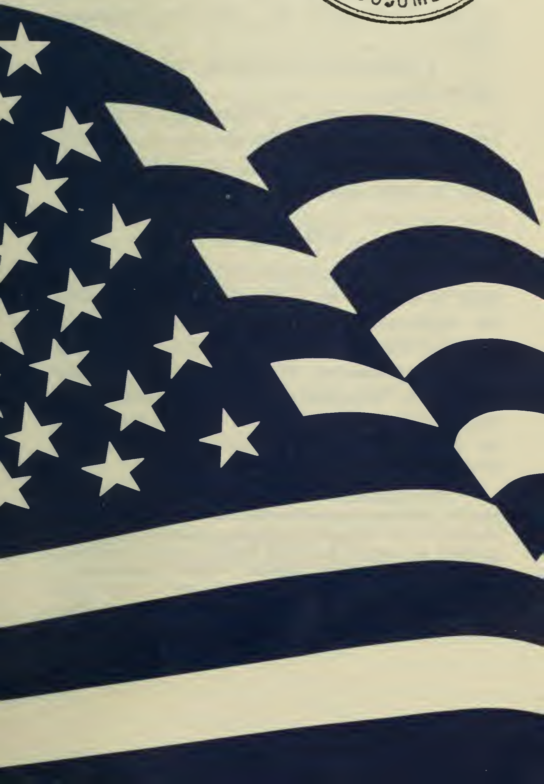
Handling Net Margins Under Federal Tax Laws

FCS Information 39

Farmer Cooperative Service

U.S. Department of Agriculture



HANDLING NET MARGINS UNDER FEDERAL TAX LAWS[1]

Section 17 of the Revenue Act of 1962, approved October 16, 1962, and amended in 1966 and 1969, added a new Subchapter T to the Internal Revenue Code of 1954.[2] It applies to all farmer cooperatives and certain other corporations operating on a cooperative basis. It is effective in taxable years that begin *after* December 31, 1962.

The law preserves the principle of a single, current tax on income produced through farmer cooperatives, provided they meet these conditions:

1. Adhere to certain requirements as to the *form* in which they distribute patronage refunds.

2. Make the distributions within the prescribed time.

In the process of conforming with the law, however, a number of alternatives are available that must be evaluated and on which decisions must be made. These are as follows:

Choice 1

A major alternative a farmer cooperative faces is whether to operate in compliance with the requirements of Section 521 of the Internal Revenue Act of 1954 as a so-called "income tax exempt" association; or whether to operate as a nonexempt organization by not meeting the requirements of Section 521. The changes made by Section 17 do not repeal or modify in any

[1]This publication was originally prepared by Raymond J. Mischler, now deceased, who at the time was an attorney in the Office of the General Counsel. It has been reviewed and revised by David Volkin, Senior Agricultural Economist and J. Warren Mather, Assistant Administrator, Farmer Cooperative Service.

[2]See Section 211, Foreign Investors Tax Act of 1966, Pub. L. 89-809, approved November 13, 1966.

way the requirements of Section 521 of the Internal Revenue Code of 1954 relating to qualification for a letter of exemption. Such a letter entitles an eligible farmer cooperative to two special deductions:

1. Amounts paid as dividends during the taxable year on capital stock (which has been construed to include any form of return on all genuine capital interests); and

2. Amounts of nonpatronage income (such as income on business with the United States, rents, and interest) paid out on a patronage basis, if distributed within 8½ months after the year in which it was derived.

Choice 2

The next choice or alternative is whether to comply with the precise rules set forth in Subchapter T of the 1954 Code pertaining to the form and time of payment of patronage refunds that will allow the cooperative to use such refunds to reduce its gross income for tax purposes. For, to emphasize, it is the *form* and *timing* of the refunds that determine their tax treatment under the law, at both the cooperative level and, in the main, at the patron level.

The law lays down precise rules on the circumstances under which farmer cooperatives (both "exempt" and nonexempt) may use patronage refunds to reduce their gross income for tax purposes. They are:

First—The refund must meet the definition of a "patronage dividend" set forth in the statute. This means that the refund must be:

1. Computed on the basis of quantity or value of business done with or for the patron;

2. Made pursuant to a pre-existing written obligation of the cooperative; and

3. Determined by reference to the net earnings of the organization from business done with or for patrons. (This excludes true "capital retains" from sales proceeds.)

In 1966, however, the law was amended to provide similar treatment for capital retains. In general, these are amounts allocated to patrons as evidence of capital they furnish on the basis of the dollar value or physical volume of products marketed through the cooperative. The amounts so allocated are invested without reference to the cooperative's "net earnings."

Second—The refund or per-unit retain allocation must be paid in cash, property of a kind on which a current value can be placed, or in what the statute calls "qualified written notices of allocation," or in the case of capital retains, "qualified per-unit retain certificates."

Third—The refund must be "paid" within 8½ months following the close of the cooperative's fiscal year. (The statute calls the 12-month fiscal year *plus* this 8½ months period the cooperative's "payment period.")

If the cooperative does *not* comply with these rules, it could not exclude patronage refunds from taxable income and thus would be subject to taxation on them at the corporate rate.

Choice 3

A third area of choice is whether to use "qualified written notices of allocation." In all cases, these allocations to be "qualified" must meet the following requirements:

1. They must be in the form of a document that discloses the *amount* of the allocation and the *portion* thereof that is a patronage dividend (as compared to distributions of non-patronage income);

2. At least 20 percent of this patronage dividend must be paid in cash. (No 20 percent payment is required to "qualify" capital retains).

At this juncture, however, the cooperative can choose between issuing the paper (1) under circumstances in which it has a form of patron's consent, or (2) in a form redeemable in cash by

the patron within a period of 90 days following the date of issuance.

If the cooperative decides to pay some or all of its patronage refunds in the form of *non-qualified* written notices of allocation, it can do this simply by failing to comply with one or all of the requirements as to the form and timing of the allocation previously discussed. In this event it incurs a current tax liability. A deduction is available, however, when the nonqualified allocation is redeemed in cash.

Choice 4

If the cooperative elects to get a form of patron's consent, it has three available ways to do this:

1. *Individual patron's written consent*

This form of consent must be given to the cooperative before the end of the year in which the patronage occurs. It applies to all patronage in that year. It also covers patronage in subsequent taxable years until a written revocation becomes effective.

A revocation is effective only on patronage occurring after the close of the cooperative's taxable year in which it is given.

2. *Bylaw consent*

The patron may consent by obtaining or retaining membership in a cooperative having bylaws that require members, as a condition of membership, to take qualified written notices of allocation into account currently in computing their Federal income tax liability.

The bylaw must have been adopted after October 16, 1962, (November 13, 1966, in the case of capital retains), and it must clearly set forth this obligation. The consent under their

method becomes effective only on patronage occurring after each patron receives a written notification of the adoption of the bylaw that explains its significance. A copy of the bylaw must accompany the notification.

Mailing this material by ordinary mail to the patron's last-known address is permitted. New members must have this material *before* becoming members. Termination of membership terminates this form of consent.

3. *Consent by qualified check*

If neither of the first two methods is applicable, a patron may consent by endorsing and cashing a check or other instrument redeemable in money that represents at least 20 percent of the total patronage refund, and has clearly imprinted on it that endorsing and cashing it will constitute such consent. (The qualified check consent does not apply to capital retains.)

This endorsement and cashing must take place within 90 days following the end of the cooperative's payment period (see definition previously given to constitute a valid consent).

This latter method is a "one shot" deal, applying only to the patronage refund of which the check is a part.

Choice 5

Under the final regulations (28 Fed. Req. 3152) a cooperative qualifying under Section 521 has two further choices which, if exercised, will not jeopardize its so-called "exempt" status.

1. It may pay patronage refunds or capital retains of less than $5 in nonqualified allocations even to consenting members; or

2. If it issues, to nonconsenting patrons, nonqualified patronage allocation or nonqualified

per-unit retain certificates, which are interest-bearing or in the form of dividend-paying stock, it may make deductions (reasonable in relation to the fact that it receives no tax benefit on such allocations until redemption) in the interest or dividends paid.

The foregoing analysis suggests that there is a substantial amount of flexibility in the Code provisions. Farmer cooperatives do, in fact, have alternative methods of handling net margins under Federal tax laws. Each cooperative must determine the courses that will best fit its particular operations.

Other Publications Available

Federal Income Taxes. Part II-Legal Phases of Farmer Cooperatives. D. Morrison Neely. FCS Information 100, 1976. 195 pp.

A Financial Profile of Farmer Cooperatives in the United States. Nelda Griffin. FCS Research Report 23. 1970. 95 pp.

Tax Laws Changed on Capital Retains. David Volkin and D. Morrison Neely. FCS Reprint 328. 1967. 4 pp.

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FARMER COOPERATIVE SERVICE
U.S. DEPARTMENT OF AGRICULTURE

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The Service (1) helps farmers and other rural residents obtain supplies and services at lower cost and to get better prices for products they sell; (2) advises rural residents on developing existing resources through cooperative action to enhance rural living; (3) helps cooperatives improve services and operating efficiency; (4) informs members, directors, employees, and the public on how cooperatives work and benefit their members and their communities; and (5) encourages international cooperative programs.

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